STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

AQUA ILLINOIS, INC. and ILLINOIS-AMERICAN WATER COMPANY	)	Docket No. 15-0017
Development and adoption of rules amending 83 Illinois Administrative Code Part 656, Qualifying Infrastructure Plant Surcharge	)	

INITIAL COMMENTS OF THE PEOPLE OF THE STATE OF ILLINOIS TO THE PROPOSED DRAFT RULE ON QUALIFYING INFRASTRUCTURE PLANT SURCHARGES

The People of the State of Illinois, by and through Lisa Madigan, Attorney General of the State of Illinois ("AG" or "the People"), file the following Initial Comments in response to the Joint Petition of Aqua Illinois, Inc. ("Aqua") and Illinois American Water Company ("IAWC") (Aqua and IAWC together, the "Joint Petitioners") to amend 83 Ill. Admin. Code Part 656, Qualifying Infrastructure Plant Surcharge, as filed on January 7, 2015.

INTRODUCTION

The Joint Petitioners propose several fundamental changes to the function of the qualifying infrastructure plant ("QIP") surcharge. These changes would drastically increase upward pressure on customer rates, generating instability and budgetary concerns for many Illinois citizens. They also would radically alter the purpose of the QIP surcharge and undermine the stability and incentives that are part of the general ratemaking process. For the reasons set forth below, the Joint Petition should be denied.

Notably, the Joint Petitioners in this proceeding did not attach testimony or any factual data in support of their proposal. The Petition spends approximately three pages discussing the

need for the proposed changes to the Rules, asserting first that "much of the infrastructure they use to provide [water and sewer] services is nearing the end of its life expectancy" (Pet. at ¶ 3), without quantifying the term "much." The Petition then asserts that Aqua has identified $200 million of necessary pipe replacements in two service areas and that IAWC spent $47 million on infrastructure projects in 2014 (*id.*), but does not explain how the existing QIP surcharge rules or the traditional ratemaking process are insufficient to provide for recovery of these types of costs. The Petition then asserts that the capital and depreciation costs associated with infrastructure replacement "require significant rate relief" (Pet. at ¶ 4) but does not explain why the current ratemaking and QIP surcharge processes do not provide sufficient revenues.

The Petition then describes the history of the QIP surcharges for Aqua and IAWC and extols the alleged advantages of the QIP surcharge (Pet. at ¶¶ 5-8), concluding that the QIP surcharges "have permitted Aqua and IAWC to continue to provide adequate, efficient, reliable, and least cost service while continuously investing in necessary infrastructure improvements." One is thereby left pondering the adage about things that "ain't broke." The Petition then asserts that growing need for infrastructure replacement and increased costs create a need to expand the scope and size of QIP surcharge recovery (Pet. at ¶¶ 9-10) but makes no gesture at describing the particular plant that requires replacement, quantifying the purported increased costs or justifying a particular level of QIP surcharge recovery needed to cover such costs.

In response to the Petition, the People first argue the Commission should modify Section 656.60 to allow for the adjustment of infrastructure costs by accumulated deferred income tax ("ADIT"). The People next take issue with the Joint Petitioners' three offered amendments to 83 Illinois Administrative Code Part 656. First, the Joint Petitioners propose replacing the static 5% cap on the QIP surcharge with a 2.5% annual average increase limit. Pet. Ex. A, page 2.

Second, the petitioners seek to expand the number of accounts for which the QIP surcharge revenues can be collected. Through this amendment, the scope of the QIP surcharge collection for water would spread from 4 accounts to 33 accounts, and the QIP surcharge collection for sewer service would increase from 3 accounts to 29 accounts. Pet. Ex. A, page 4. Third, the petitioners propose removing a provision authorizing the Illinois Commerce Commission ("Commission" or "ICC") to conduct a hearing to potentially cancel QIP recovery for a water utility if the annual reconciliation shows QIP revenues surpass QIP costs for three or more consecutive reconciliation years, an important provision to promote administrative efficiency. Pet. Ex. A., page 16.

As discussed more fully below, the People request that the Commission deny the requested changes to the QIP surcharge rule. If any change to the rules is made, it should be limited to providing for the adjustment of the infrastructure costs to reflect the use of ADIT.

I. The Commission should Modify Section 656.60 to Adjust NetQIP for Accumulated Deferred Income Taxes.

Today, unlike the gas infrastructure rider rule,[1] the water QIPS rule does not adjust the QIP balance by "accumulated deferred income taxes," or "ADIT." Both the Commission and Illinois courts have long recognized the fundamental regulatory concept that "accumulated deferred income taxes," or "ADIT," represent ratepayer-supplied funds that the utility can invest cost free. *See, e.g., Ameren Illinois Co. v. Illinois Commerce Commission*, 2013 IL App (4th) 120081 ("*Ameren*") at ¶ 40 ("As it was consistent with the common practice of the Commission to include ADIT in the ratemaking process, we conclude the Commission did not err by including the ADIT adjustment for projected plan [sic] additions in its ratemaking calculation.");

[1] 83 Ill. Admin. Code § 556.60(b) provides: "NetQIP = Actual cost of QIP less accumulated depreciation and **any accumulated deferred income tax liabilities net of deferred tax assets resulting from the additional QIP**." (emphasis added).

Commonwealth Edison Co. v. Illinois Commerce Commission, 405 Ill.App.3d 389. 402 (2d Dist. 2010). The Court in *Ameren* recognized that ADIT represents interest-free investment dollars upon which the utility should not be allowed to charge a return, stating:

> The Commission asserts that ignoring the ADIT figure would do just that—allow Ameren to recover an unjust and unreasonable rate base that has been inflated by no-cost capital for the benefit of Ameren. We agree. Omitting ADIT from the rate base calculation would allow Ameren what amounts to an interest-free loan at the ratepayers' expense that would artificially increase Ameren's rates until the next reconciliation process, a result which is neither just nor reasonable for ratepayers.
>
> Although the Modernization Act does not expressly provide for the Commission to reduce the rate base by ADIT, the ratemaking process under the Modernization Act is ultimately subject to the Commission's discretion and authority to determine whether those rates are just and reasonable in accordance with the Commission's practice and law. 220 ILCS 5/16-108.5(c)(6)(West 2012).

Ameren, at para. 39. Any changes to the water QIP investment surcharge must recognize this source of ratepayer-supplied funding and be designed so that consumers are not charged a return on this non-investor funding.

The proposal to rewrite the QIP surcharge rule to include most of the utilities' accounts and to allow water and sewer bills to increase by an average of 2.5% each year runs the risk of replacing much of traditional ratemaking with an investment-specific process. Given the size of the surcharges being contemplated, it is essential that consumers only pay for investor-supplied funds. Failing to reduce the QIP surcharge for ADIT funding would be "neither just nor reasonable for ratepayers," as the *Ameren* court pointed out. *Id.*

Both Aqua and IAWC stated in response to AG data requests AQ-AQUA 3.1 and AG-IAWC 3.1, respectively, that they have not deducted ADIT from the NetQIP value when calculating the QIP surcharge pursuant to Section 656.60 of the Commission's Rules. As a

result, consumers today are paying a return on ratepayer-supplied funds. This ratemaking oversight should be corrected regardless of whether the other changes requested by the Joint Petitioners are allowed.

As discussed above, the Commission rule governing the natural gas infrastructure rider requires the utilities to deduct ADIT when calculating the NetQIP amount. Section 556.60(b) of the Commission's gas infrastructure rider rule defines NetQIP as follows:

> NetQIP = Actual cost of QIP less accumulated depreciation and **any accumulated deferred income tax liabilities net of deferred tax assets resulting from the additional QIP**. [emphasis added]

This language should be incorporated in the water QIP surcharge rule, and the definition in Section 656.60(b)(1) should be revised to read:

> NetQIP = The average forecasted cost of the investment in QIP for the rate zone for the operation year less forecasted accumulated depreciation in QIP for the rate zone for the operation year <u>and any accumulated deferred income tax liabilities net of deferred tax assets resulting from the additional QIP.</u> The average forecasted cost of QIP, net depreciation, shall be computed by using an average of 13 end-of-month balances of QIP and accumulated depreciation for the period from December 31 of the year preceding the operation year through December 31 of the operation year. [emphasis added]

This change should be made to the water and sewer QIPS rule regardless of whether the expansion requested by the Joint Petitioners is granted so that the QIP surcharges are not inflated by charging consumers a return on cost-free ADIT.

II. The proposal to adopt a 2.5% annual increase limit and remove the 5% cap would have substantial, unnecessary rate impacts on customers.

Under the current rule, utilities cannot increase customer bills by more than 5% as a result of the QIP surcharge. 83 Ill. Adm. Code § 656.30(a). The surcharge is a percentage charge "applied to the total amount billed to each customer located in the same rate zone." *Id*. at

§ 656.60(a). The Joint Petitioners propose removing this cap and replacing it with a 2.5% *annual increase* limit. Pet. Ex. A, page 2. In a given year, the QIP surcharge may increase up to 3.5% so long as the annual average increase is 2.5%. *Id.* Such a change to existing regulations could generate a sharp acceleration in utility rates for Illinois customers. For example, IAWC's last general rate increase was two and a half years ago. ICC Docket 11-0767, Final Order (September 9, 2012). If this rule had been in effect, IAWC customers would already be exposed to a 7.5% increase in three years without a new rate order being sought.

The Petitioners have not shown that this increase is necessary. First, from the rate case and QIPS filings made over the last several years, it is apparent that the charge for improvements does not need to increase each year. Between 2009 and 2013, IAWC's annual utility plant investments fluctuated with no clear upward or downward trend. Docket No. 11-0767, Direct Testimony of Jeffery T. Kaiser, IAWC Ex. 3.0 at 4:87-5:106 (see pp. 6-43 for more specific accounting of IAWC's major individual improvement plans from the years 2009 to 2013). For water, IAWC invested $79.6 million in utility plant placed in service in 2009, $77.5 million in 2010, and $12.3 million in the first six months of 2011. *Id.* The Company planned on investing an approximate annualized average of $72.7 million from the last 6 months of 2011 through September 30, 2013. *Id.* For sewer, IAWC invested approximately $5.7 million in utility plant in service in 2009, $4.4 million in 2010, and $2.3 million in the first six months of 2011. *Id.* It planned on investing an approximate annualized average of $5.2 million from the last 6 months of 2011 through September 30, 2013. From these figures, there is no clear upward or downward pattern in investment costs for IAWC. Since utility plant investments are within predictable ranges, the proposed 2.5% annual average increase does not appear to be necessary.

Second, the proposed 2.5% average annual increase could lead to a substantial impact and destabilizing effect on consumer rates as the QIP surcharge would accumulate over the years at an increasingly rapid pace. If utilities implemented this 2.5% annual increase limit to its fullest extent each year, the QIP surcharge amount could reach up to 7.5% within only three years. Docket No. 15-0017, Aqua Response to Data Request AG-AQUA 2.01 (Kankakee Division), IAWC Response to Data Request AG-IAWC 2.01R (Chicago Collection District) (both attached together as **Exhibit A**). The current 5% cap creates a ceiling for the QIP surcharge increases and encourages the utilities to pace their investments so that rate impacts are moderate. The Joint Petitioners' proposal would remove this ceiling and generate a substantial upward trend in charges that the Petitioners have not shown is necessary.

III. The proposal to expand the number of accounts subject to the QIP surcharge would further burden customers and alter the very purpose of the QIP surcharge and rate base ratemaking.

Under Part 656 of the Commission's Rules, water utilities may recover QIP costs for improvements under four accounts: 331, 333, 334, and 335. 83 Ill. Adm. Code § 656.40(b). Sewer utilities may recover QIP costs under three accounts: 360, 361, and 363. 83 Ill. Adm. Code § 656.40(c). The Joint Petitioners propose substantially expanding the accounts recoverable under the QIP surcharge. Petition, ¶ 11; Pet. Ex. A, page 4. Through this amendment, the QIP surcharge would be expanded to include water accounts 304 through 336 (ten additional accounts), and sewer accounts 354 through 382 (nine additional accounts). *Id.* *See also* 83 Ill. Adm. Code § 605.304-.335 and 83 Ill. Adm. Code §650.354-.382. This proposal would greatly expand the function of the QIP surcharge from a targeted surcharge to address a specific need to a broad ratemaking mechanism, creating several troubling implications.

First, the Petitioners have not described why the current plant accounts are inadequate to satisfy the QIP statute. Section 9-220.2 of the Public Utilities Act provides:

> (a) The Commission may authorize a water or sewer utility to file a surcharge which adjusts rates and charges to provide for recovery of … (iv) costs associated with an investment in qualifying infrastructure plant, independent of any other matters related to the utility's revenue requirement. A surcharge approved under this Section can operate on an historical or a prospective basis.
>
> (b) For purposes of this Section, "costs associated with an investment in qualifying infrastructure plant" include a return on the investment in and depreciation expense related to plant items or facilities (including, but not limited to, replacement mains, meters, services, and hydrants) which (i) are not reflected in the rate base used to establish the utility's base rates and (ii) are non-revenue producing. For purposes of this Section, a "non-revenue producing facility" is one that is not constructed or installed for the purpose of serving a new customer.

220 ILCS 5/9-220.2. Petitioners have not shown that the expanded accounts represent plant that is a "'non-revenue producing facility'" … that is not constructed or installed for the purpose of serving a new customer." *Id.* If these plant accounts do not meet this definition, they cannot lawfully be included in the QIP surcharge. The Petitioners should be required to demonstrate that these accounts are properly included before the QIP rule is expanded so greatly.

As a result of discovery conducted by the People, it is apparent that placing so many accounts into the QIP surcharge can be expected to drive up spending in potentially extraneous accounts and have a substantial effect on consumer rates. In 2013, for instance, Aqua invested a total of $1,243,412 within the accounts the Joint Petitioners wish to add to the QIP surcharge. Docket No. 15-0017, AG-Aqua Response to AG Data Request 2.03, Attachment 01 (attached hereto as **Exhibit B**). In the accounts currently within the QIP surcharge, Aqua invested a total of $10,511,041 that same year. *Id.* Assuming the accounts represent investment that qualifies

as QIP under the statute, adding the proposed accounts would have increased the surcharge amount by approximately 11.8%. *Id.* It is also true that Aqua estimates that the existing QIP accounts will comprise 40% of Company capital expenditure during the next five years, while the proposed new QIP accounts will comprise 5%. Aqua responses to data requests AG-AQUA 2.06 and 2.07 (attached hereto as **Exhibit C**).

Second, placing more accounts into the QIP surcharge may improperly incentivize replacements over repairs. The QIP surcharge structure tends to skew the repair/replace decision by incentivizing utilities to replace infrastructure rather than repair it. Typically, utilities must manage repair and maintenance costs until the next rate case. However, through the QIP surcharge, petitioners can immediately recover additional money from customers by replacing plant. As a result, the QIP surcharge increases on the margin the incentive to prematurely and uneconomically replace plant when repairs may have been more appropriate. Including so many accounts under the authorization for QIP surcharge recovery would further skew this incentive.

Third, the extent of the change Petitioners request would undermine the operation and incentives associated with traditional ratemaking, as significantly fewer costs and accounts would be subject to management between rate cases and review within rate cases. Under traditional ratemaking, utilities manage their operations to achieve savings that will offset cost increases. For example, the replacement of mains could reduce maintenance expenses or decrease unaccounted-for water leaks and the utility would manage the savings as well as the costs between rate cases. The QIP surcharge, on the other hand, helps to sever the underlying relationship between utility rates and levels of costs and investment since the automatic adjustment mechanism allows increased rates and revenues outside the context of a thorough rate review.

Petitioners conceded that the QIP surcharge rule was intended to bridge any "regulatory lag" between rate cases. Petition, ¶ 7. Yet placing so many accounts into the QIP surcharge amount can grant the surcharge a much larger role in setting rates with adjustments occurring several times a year. 83 Ill. Adm. Code § 656.70 (information sheets setting the rate can be filed up to quarterly) and 83 Ill. Adm. Code § 656.80 (annual reconciliation). What was originally an exception to ordinary rulemaking would essentially swallow the rule, requiring multiple filings and rate changes outside the context of a rate case.

Accompanying the expansion of the QIP accounts, the Commission would face a much larger burden in evaluating the merits and prudence of each claimed improvement plan under the QIP surcharge reconciliation process. See, e.g., *Illinois-American Water Co.*, ICC Docket No. 10-0202, Order, July 12, 2011, at 5 ("under Section 9-220.2(c), only prudently incurred costs are recoverable through a surcharge under Part 656"). The size of improvement plans could increase drastically, following the increased number of accounts included under the QIP surcharge. For each plan, the Commission would need to verify that each improvement was in fact replacing existing infrastructure, non-revenue producing, and not installed to serve additional customers. 220 ILCS 5/9-220.2(b); 83 Ill. Adm. Code § 656.40(a)(3); *also see* definition of "Qualifying infrastructure plant" at 83 Ill. Adm. Code § 656.20. The Commission would also have to verify that the "replacements are installed to replace facilities that are worn out or deteriorated or to replace facilities that are obsolete and at the end of their useful service lives" as described in the rules. 83 Ill. Adm. Code § 656.40(a). This process could become highly burdensome as the number of QIP accounts and the size of the adjustments increase.

The proposed changes also expand the definitions of plant that the QIP surcharge would include. The Petitioners request that Subsection 656.40 redefine QIP to expand projects to those

that "eliminate water loss from water main breaks" (Pet. Ex. A at 4) and a host of sewer related maintenance, such as main and manhole "lining/grouting" and rehabilitation to eliminate inflow and infiltration (Pet. Ex. A at 5). Yet, Petitioners offered no evidence or explanation of why these expansions are needed, how these expenses are different from current expenses or ordinary utility maintenance functions, or how these changes comport with the statutory requirements. The Commission should not expand the QIP surcharge rule without a full understanding of the requested changes and their implications.

IV. The implications of the proposed change to Section 656.40(e) require further explanation and review.

The Petition requests that Section 656.40(e) be modified to reconcile "projected QIP plant included in rate base in the utility's last rate case … with the actual cost of the QIP plant incurred as of the end of the projected test year in the utility's last rate case filing." The implications of this provision are unclear. It appears to modify the Commission's future-test-year rule by allowing the utility to charge consumers a return on year-end investment even if the future test year does not correspond with the calendar year. Would discrepancies between the future test year and the QIP filing be collected in the reconciliation or added to a new QIP surcharge? Or would base rates be modified to reflect "actual cost of the QIP plant incurred as of the end of the projected test year"? The Petitioners should be required to provide evidence to demonstrate how this ambiguous language would be applied.

V. The proposal to remove the provision authorizing the Commission to conduct hearings to cancel a QIP surcharge if QIP revenues exceed QIP costs for three or more consecutive years would remove necessary accountability over the QIP surcharge.

Under Section 656.80(j) of the current QIP surcharge rule, the Commission may initiate a hearing pursuant to 220 ILCS 5/9-250 to decide whether to cancel a QIP surcharge if the annual

reconciliation shows QIP revenues exceed QIP costs for three or more consecutive years. 83 Ill. Adm. Code § 656.80(j). This provision provides the Commission an important avenue to monitor the operation of QIP surcharges and to assure that they are in fact needed and performing as intended. Given the lack of information offered by the Joint Petitioners supporting their request for the significant increase in QIP surcharge amounts, the Commission should reject the Joint Petitioners' request to remove this key provision. Such a removal carries many concerning implications.

First, eliminating the Commission's option to investigate the need for QIP surcharges would result in a substantial loss of accountability and administrative efficiency. The purpose of the QIP surcharge is to allow utilities to recover costs incurred between ratemaking proceedings. Section 656.80(j) allows for the removal of a QIP surcharge when utilities are not just recovering costs through the surcharge but rather receiving revenues that exceed actual QIP costs for three or more consecutive reconciliation years. In such cases, there is no need for the surcharge. Removing Section 656.80(j) as proposed would create a risk and burden of a QIP surcharge that did not need to be there. It would also potentially lead to the Commission and utilities engaging in unnecessary, avoidable proceedings.

Second, the utilities have not shown that this precautionary provision has operated as a burden on the process or on the utilities. Section 656.80(j) adds an insignificant burden on the Joint Petitioners. The provision merely states that the Commission *may* initiate hearings to determine whether they should cancel a QIP surcharge, if a QIP surcharge appears to be unnecessary. Again, the purpose of the surcharge is to allow utilities to recover improvement costs and not to recover any greater amount. If a QIP surcharge is not needed for three consecutive years because the utility is receiving sufficient earnings to cover its investment

obligations, then a provision allowing the Commission to consider whether to remove the QIP surcharge is an important protection that should impose no cost on the utility. In these instances, the Commission should have the option to cancel the QIP to minimize administrative burdens on both the utilities and the Commission. Removing Section 656.80(j) is therefore unnecessary, and the Joint Petitioners have not met their burden to prove otherwise.

CONCLUSION

The Joint Petitioners have not provided evidence to support the major changes they request. For the reasons set forth above, the Commission should reject the proposed changes, and require an evidentiary basis prior to making any of the requested changes.

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Respectfully submitted,

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